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Communiqué

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Remove restraints on business activity, improve information release to retail clients of financial services, says C.D. Howe Institute study

Restraints on types of business activity among financial institutions, including bank mergers, should be removed, subject to prudential concerns, to encourage competition and resource allocation, says a *C.D. Howe Institute Commentary* released today. Moreover, the study says, given the great difference in the level of sophistication of financial institutions and householders, retail clients of banks, mutual funds, and pension funds need more and clearer information about the risks involved.

The study, *Revising Canada's Financial Regulation: Analyses and Recommendations*, was written by professors Edwin H. Neave and Frank Milne of Queen's University, and is the first in a series of special Institute Commentaries called “The Banking Papers.”

Neave and Milne argue that proposals for reform of the Canadian financial services industry must recognize the profound shifts of the past 25 years and the likelihood that they will continue. This continuing rapid change, the authors say, increases the urgency of keeping the regulatory framework up to date and presents regulators with the challenge of guiding financial system evolution while avoiding the imposition of overly stifling restrictions.

According to Neave and Milne, the principal goals of regulation should be to encourage competitiveness while satisfying prudential concerns. Regulation cannot prevent failure, nor should it try to do so, they argue, but effective regulation should encourage executives to manage prudently the risk-to-reward ratios of projects they undertake.

The authors' recommendations include the following:

- *Retail versus wholesale transactions*. Because of the informational differences, retail transactions should generally be subject to more stringent disclosure standards than wholesale transactions among sophisticated counterparties.
- *Deposit insurance*. Full coverage up to $60,000 should continue, but for each individual's dealings with a given financial institution, rather than for each account. Risk-adjusted premiums are a useful incentive for prudent management but, in some cases, increasing premiums might not be a sufficient incentive for obtaining it.
- *Securities trading*. Urgent attention should be given to the formation of a national securities commission.

- *Equality of treatment*. Banks are currently limited in their ability to offer insurance products, an anticompetitive limitation that should be removed. Nor should banks be prevented from offering leases. Similarly, insurance companies should have access to the payments system, so long as they satisfy prudential concerns and pay appropriate access charges.
- *The payments system*. Access to the payments system, especially Interac, is now an important determinant of competitive ability. Different risks may be posed if different classes of firms obtain access in the future. The original Interac members are entrepreneurs who have created an economically valuable entity and who are entitled to a fair return on their investment.
- *Equity ownership*. The market for effective control could be improved by relaxing, over the long term, the 10 percent limitation on the ownership of shares of banks and some other intermediaries.
- *Emerging risks*. As financial institutions enter new businesses and merge to form new kinds of business combinations, they may assume risks with which they are unfamiliar. Regulators should try to anticipate emerging difficulties and should be granted the resources to deal with such problems as they arise.
- *Fire and casualty insurance companies*. Functional analysis suggests that fire and casualty insurance companies are financial intermediaries and should be treated as such.
- *Consumer responsibility*. Every effort should be made to ensure both that consumers have incentives to assess the risks they are taking and that unscrupulous individuals do not find ways to take advantage of householders' lack of sophistication.
- *Information release*. Since making nonstandardized asset portfolio valuations less opaque is difficult unless supervisory information is published, all deposit insurance funds and the Office of the Superintendent of Financial Institutions should publicize what they deem pertinent indicators of supervised institutions' financial condition. Procedures for releasing the information should be worked out in consultation with industry representatives to ensure it is as reliable as possible and to avoid arbitrary impositions of regulatory judgments.

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Communiqué

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Éliminez les contraintes imposées aux activités commerciales et améliorez la diffusion des renseignements aux clients de détail des services financiers, suggère une étude de l'Institut C.D. Howe

Il faut éliminer les contraintes imposées aux activités commerciales des institutions financières, dont la fusion des banques, sous réserve de considérations de prudence, afin de favoriser la concurrence et l'attribution des ressources, affirme un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. Par ailleurs, indique l'étude, étant donné la différence importante du degré de connaissances qui distingue les institutions financières des particuliers, qui sont les clients de détail des banques, des fonds de placement et des régimes de pension, ceux-ci devraient offrir davantage de renseignements et une précision accrue concernant les risques qu'ils présentent.

L'étude, intitulée *Revising Canada's Financial Regulation: Analyses and Recommendation, (Révision de la réglementation du secteur financier au Canada : analyses et recommandations),* est rédigée par Edwin H. Neave et Frank Milne, professeurs à l'Université Queen's, et représente le premier d'une série de Commentaires spéciaux de l'Institut intitulés « Les cahiers bancaires ».

MM. Neave et Milne soutiennent que les propositions de réforme du secteur des services financiers canadiens doivent tenir compte des modifications profondes des 25 dernières années et de l'éventualité qu'elles se poursuivent. Selon les auteurs, ces changements rapides soulignent l'urgence de mettre le cadre réglementaire à jour et posent un défi aux organismes de réglementation, qui est celui de guider l'évolution du système financier tout en évitant l'imposition de restrictions qui sont trop oppressantes.

Selon MM. Neave et Milne, les principaux objectifs de la réglementation devraient être de favoriser la compétitivité tout en tenant compte des considérations de prudence. La réglementation ne peut empêcher les faillites, et elle ne devrait pas non plus essayer de le faire, soutiennent-ils, mais une réglementation efficace devrait encourager les gestionnaires à gérer avec prudence le rapport risque-avantage des projets qu'ils entreprennent.

Parmi les recommandations des auteurs figurent notamment les suivantes :

- *Transactions de détail et transactions de gros.* En raison des différences informationnelles, les transactions de détail devraient généralement faire l'objet de normes de présentation plus strictes que les transactions de gros qui se déroulent entre des contreparties averties.

- *Assurance-dépôt*. La garantie complète d'un montant maximum de 60 000 $ devrait se poursuivre, mais elle devrait porter sur toutes les transactions d'un individu au sein d'une institution financière donnée, plutôt que sur chaque compte. Les primes qui tienent compte du risque sont une stimulation utile envers la gestion prudente, mais dans certains cas, l'augmentation des primes pourrait s'avérer insuffisante pour y parvenir.
- *Commerce des valeurs mobilières*. Il faut accorder une attention urgente à l'établissement d'une commission nationale des valeurs mobilières.
- *Égalité de traitement*. Les banques disposent de peu de latitude pour offrir des produits d'assurance, et c'est là une limitation anticoncurrentielle que l'on devrait éliminer. On devrait également permettre aux banques d'offrir des services de crédit-bail. Par ailleurs, les sociétés d'assurance devraient être en mesure d'accéder au système des paiements, tant qu'elles répondent aux normes de prudence et qu'elles paient des frais d'accès correspondants.
- *Système de paiements*. L'accès au système de paiements, et particulièrement Interac, est maintenant un important facteur qui détermine la capacité concurrentielle. Si des catégories d'entreprises différentes y accèdent dans l'avenir, différents risques pourraient se poser. Les membres fondateurs d'Interac sont des entrepreneurs qui ont créé une entité valable sur le plan économique et qui ont droit à un rendement valable du capital investi.
- *Participation*. On pourrait améliorer le marché du contrôle effectif en réduisant à long terme le plafond de 10 % imposé sur la propriété des actions des banques et de certains intermédiaires.
- *Matérialisation de nouveaux risques*. Au fur et à mesure que les institutions financières exploitent de nouveaux domaines et qu'elles fusionnent pour former de nouveaux regroupements d'entreprise, elles seront confrontées à des risques qui ne leur sont pas familiers. Les organismes de réglementation devront s'efforcer de prévoir les difficultés à venir et devraient disposer des ressources pour s'attaquer à ces problèmes lorsqu'ils se posent.
- *Sociétés d'assurance incendie et risques divers*. L'analyse fonctionnelle semble suggérer que les sociétés d'assurance incendie et risques divers sont des intermédiaires financiers et devraient être traitées comme telles.
- *Responsabilité des consommateurs*. On devrait déployer tous les efforts nécessaires pour veiller à ce que les consommateurs disposent des mesures d'incitation nécessaires pour évaluer les risques qu'ils prennent et afin que des personnes peu scrupuleuses ne puissent trouver des moyens de profiter du manque de connaissances des particuliers.
- *Publication de l'information*. Étant donné qu'il est difficile de rendre les évaluations de portefeuille d'actif plus transparentes à moins de rendre publique l'information de surveillance, tous les fonds d'assurance-dépôt et le Bureau du surintendant des institutions financières devraient publier ce qu'ils déterminent être des indicateurs pertinents de la situation financière des institutions sous supervision. Le processus de diffusion de l'information devrait être débattu en collaboration avec des représentants de l'industrie pour veiller à ce que les renseignements soient aussi fiables que possible et éviter l'imposition arbitraire de décisions réglementaires.

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Revising Canada's Financial Regulation:

Analyses and Recommendations

by

Edwin H. Neave
and
Frank Milne

Revision of financial regulation is much in the air today as Canadian firms struggle to meet the challenges of globalization, restructuring, and advances in electronic communication. We apply a theory of financial system function and organization to an analysis of possible regulatory reforms.

Although Canada's financial system provides high-quality services at relatively low cost, revision could improve performance in several areas. In particular, given the asymmetrical sophistication of financiers and householders, retail clients — of banks, mutual funds, and pension funds, for example — need more and clearer information about the risks they are taking. They also need continued deposit insurance, though without the current possibility of doubling their coverage through using two or more accounts at the same institution.

Wholesale clients, on the other hand, need less protection. And the institutions themselves should be free to combine types of business or set up subsidiaries as they wish, subject to the minimum regulation needed to satisfy prudential concerns, potential problems with non-arm's-length investments, and conflicts of interest.

Main Findings of the Commentary

- Similar financial functions should be administered under similar regulations. Subject to prudential concerns, constraints on types of business activity should be removed to encourage competition and hence resource allocation. Information release should be encouraged for the same reason.
- For wholesale firms, the balance of competitive and prudential concerns should tilt toward competitiveness. Prudential concerns are more important in retail markets. In the latter, informational asymmetries mean that transactions should be subject to more stringent disclosure standards than wholesale transactions between sophisticated parties.
- Every effort should be made to ensure that consumers have incentives to assess the risks they are taking and that unscrupulous individuals do not find ways to take advantage of householders' lack of sophistication.
- Current disclosure law for, and supervision of, both mutual funds and pension funds is insufficient. Both areas are now under investigation by competent bodies, and their analyses should be taken seriously.
- Deposit insurance should be continued for up to $60,000 for each individual's dealings with a single financial institution (not for each account, as is current practice).
- Forming a national securities commission should receive urgent attention.
- Innovation and financial restructuring are stifled by constraints that artificially divide up types of business or impose restrictive codes of practice. Financial firms should be able to organize affiliated capital corporations, and financial-commercial links should not be discouraged (but should receive appropriate supervision to satisfy prudential concerns).
- Banks are now limited in their ability to offer insurance and prevented from offering leases. These anticompetitive limitations should be removed. Similarly, insurance companies should be able to take deposits and to obtain access to the payments system, but subject to their satisfying prudential concerns.
- Interac, the private sector network for electronic payments, is under pressure to widen its membership. It should do so cautiously, continuing to give full access only to qualified depository intermediaries and developing a system of rating them. The originators of the network must receive a fair return on their investment.
- As financial institutions enter new types and combinations of business, they may assume risks with which they are unfamiliar. Regulators should try to anticipate changing risks and should receive the resources needed to deal with problems as they arise.
- All deposit insurance funds and the Office of the Superintendent of Financial Institutions should publicize what they deem pertinent indicators of supervised institutions' financial condition.

Several task forces and committees are working on proposals for reform of financial regulation in Canada. We believe such proposals should attempt to use the economic forces that drive changes in the financial system. Pragmatic proposals for reform must recognize the profound shifts of the past quarter-century and the likelihood that they will continue. This continuing rapid change increases the urgency of keeping the regulatory framework up to date and presents regulators with the challenge of guiding financial system evolution while avoiding the imposition of overly stifling restrictions.

We take the principal goals of regulation to be encouraging competitiveness while satisfying prudential concerns. The two goals are not fully compatible because competitiveness cannot be pursued singlemindedly without some sacrifice of safety and soundness. Nevertheless, a careful analysis of the tradeoffs involved can achieve a reasonably good balance of competitive stimuli and prudential constraints.

Regulation cannot prevent failure, nor should it try to do so. Effective regulation encourages executives to manage prudently the risk-to-reward ratios of projects they undertake. Regulatory incentives schemes can effectively achieve this goal by recognizing that firms, their managements, and their investors are entitled to the rewards that risk-taking brings. These beneficiaries must also understand, however, that they assume responsibility for unsuccessful risk-taking.

Finally, regulators should ensure that unusually risky management policies are likely to receive full publicity as early as possible, so that interested parties have a chance to assess them fully.

The *Commentary* proceeds as follows. After briefly describing the financial system in Canada today, including the changing environment and pressures for regulatory change, we outline our economic theory of financial activity. This sketch touches on the system's functions and market structures, the governance of different kinds of financial deals, the economics of change, the determinants of financial firms' organizational structures, and some of the tradeoffs involved in regulation.

With this theory as a touchstone, we turn to assessing proposed regulatory changes, considering their objectives, the treatment of similar functions, ownership and structural rules, prudential concerns, and improvements in the release of information.

A list of our recommendations closes the paper.

Today's Financial Services Industry

Regulatory redesign offers its greatest promise if it addresses the more permanent features of financial system operation. To say that today's financial services industry operates in a rapidly changing environment does not mean that all financial functions are changing rapidly. Rather, the institutions performing certain financial functions are changing more rapidly than the functions themselves. Thus, a regulatory approach focusing on the financial functions being performed has a greater chance of being effective than does one focusing principally on the system's current organization.

For example, some of today's insurance companies may operate some of tomorrow's banks, and some of today's banks may own some of tomorrow's insurance companies. Thus, if regulation focuses principally on one industry to the exclusion of another, it can quickly become dated.

A second example: the securities and financial intermediation businesses are becoming increasingly interdependent. In such an environment, focusing on intermediation to the exclusion of the securities business is not helpful.

Equally unhelpful is taking the current federal-provincial division of regulatory responsibilities as given. As a result, in this *Commentary*, we largely ignore federal-provincial questions in the belief that, if our analysis is economically sound, policymakers can solve the political problems of harmonizing regulations among jurisdictions.[1]

The Changing Environment

Global economic forces are greatly affecting the evolution of Canada's financial system. Advances in computing and communications, the growth of trade, and increases in exchange rate and interest rate volatility are stimulating a global explosion of financial innovation and the restructuring of financial firms. It is not management preference but the recognition of economic reality that is driving the proliferation of products and attenuating the former distinctions among the banking, insurance, trust, and brokerage industries.

The world's financial markets and institutions are now linked much more closely than they were 25 years ago. The potential for arbitrage profits explains both the increasing number and volume of linkages in short-term markets for trading highly liquid assets and the lack of linkages in markets for trading longer-term, less liquid assets. The latter markets still exhibit widely varying degrees of integration, and some of them are still so isolated from each other that they are best described as segmented.

Trading between segmented and integrated markets is not currently viewed as profitable, but segmentation is not a stable phenomenon. Generally, it contains the seeds of its own destruction because innovators can earn arbitrage profits if they can find new ways to link previously separated markets. Such attempts are increasingly likely as electronic transactions become still cheaper and more widespread. Transaction costs no longer grow with the distance between participants. With electronic access, financial firms anywhere in the world can reach clients cheaply, and small as well as large firms can reach particular client groups.

Pressures for Regulatory Change

The workings of global economic forces have implications for firm size, for the type of firm ownership, and for prudential regulation. Consider each in turn. Firms seeking to reduce costs look for economies of scale and scope, and their ability to realize such economies drives increases in institutional size. The largest firms can also appeal to international investors, their attraction being enhanced by a tendency toward freer international trade in services.

In this environment, ownership restrictions can inhibit efficiency by sheltering management from takeover bids. Such restrictions can also conflict with international agreements. The changing environment is even affecting prudential regulation. New combinations of financial activities mean that prudential regulation has to address the risks of corporate entities, no matter where they are located or what types of businesses they combine.

Canada's financial regulation must be sensitive to these changes in the world business environment. International financial business responds quickly to differences in prospects for profitability, so if Canada's regulation is more costly than that of other similar countries, it is likely to lose business.

For example, if Canada taxes the international business of its institutions more heavily than do other developed countries, those firms are placed at a competitive disadvantage. Similarly, if Canada's accounting standards differ from those of other comparable jurisdictions — say, in the way they recognize intangible assets acquired through mergers or takeovers — its institutions may face taxation rates that are effectively higher than those the institutions of other countries face.

Theory

Assessing proposed regulatory revision requires an economic theory of financial activity. This section presents the theory we use. We examine system functions, how financial deals are governed, and the operating economics of firms performing those functions. Next, we examine the forces driving change in the financial system and the economics underlying firms' organizational structures. Finally, we consider the implications of these economics for framing regulation.

System Functions

Understanding the principal functions financial systems perform helps analysts interpret current organizational change. And understanding change allows us to propose regulatory revisions capable of working with, rather than in opposition to, the forces of change.

The principal function of a financial system is to allocate financial resources to their best uses. This resource allocation function can be subdivided in at least two ways: by the types of functions performed, and by the types of markets in which functions are performed.

Resource Allocation Functions

Crane et al. argue that the primary purpose of a financial system is to allocate financial resources to their best uses. For analytic purposes, the coauthors distinguish six core aspects of this allocation function.[2]

First, the financial system clears and settles payments and thus facilitates such economic activities as trade and investment. Second, a financial system facilitates pooling resources; in particular, it provides ways of subdividing shares in different businesses. Third, the resource allocation task is one of transferring financial resources through time, across borders, and among industries.

Fourth, the financial system facilitates risk management, in particular by providing ways of dividing and transferring the risks incurred in conducting different businesses. Fifth, the financial system provides information regarding the risks and returns generated by particular activities. Analyses sometimes assume implicitly that financial system information is public information, but, in fact, financial intermediaries develop a great deal of information that is mainly used privately.

Sixth, the financial system provides ways of managing incentive problems. Economic incentives influence financial firms' chosen size and organizational structure (effects described in a later subsection). Economic incentives also govern the ways in which particular financial deals are set up.

Deals differ qualitatively because they arise under various informational conditions, each of which creates its own variety of incentives. The management of different informational conditions and the incentive problems they create is addressed using different forms of financial governance structures (as outlined below).

Governance structures themselves can be assessed according to the three principal functions involved in drawing up financial contracts: screening, designing the nature of monitoring, and providing for contract adjustment as and where needed.

Functions and Market Structures

Financial products and services can be sold in different kinds of markets. For regulatory purposes, a distinction between wholesale and retail markets helps to identify different informational and incentive conditions under which transactions are consummated.

A *wholesale transaction* is one that either involves the transfer of a large amounts of funds or provides services of relatively high value. In contrast, a *retail transaction* is one carried out by or on behalf of an individual householder or small business.

Parties to wholesale transactions are generally of comparable sophistication, and they deal under conditions of symmetric information — that is, clients can be presumed to have at least potential access to the same transaction information as the financiers with whom they deal. On the other hand, the parties to a retail transaction are rarely of comparable sophistication; householders and small businesses generally have less access to transaction information than the financiers with whom they deal.

Sophisticated and Unsophisticated Parties

When relatively unsophisticated clients deal with sophisticated financiers, informational asymmetries are more likely to be present than when both parties are equally sophisticated. When transactors are not of comparable sophistication, the effectiveness of disclosure laws can be limited because disclosure may not prove informative to the less sophisticated party. For example, proposals assuming that consumers can learn to assess the solvency of the banks in which they place their deposits impose quite unrealistic information-processing demands on those depositors.[3] Regulators must design other forms of protection from the asymmetries' consequences.

Similarly, the average consumer cannot reasonably be expected to understand the degree of safety represented by the assets in her pension fund. Compounding this problem, the size of her own investment may well make it uneconomic for her to develop information on her own, and default insurance may not be available to her at competitive market prices. As a result, she merits certain kinds of protection against maladministration of her assets.

Wholesale transactions do not require the same protection in law as their retail counterparts. If informational asymmetries pose possible disadvantages in such transactions, information trading will likely spring up, or the parties will find it cost effective to pay monitors to assess the likely effects. If such markets in information fail to emerge, sophisticated players will likely pressure regulators to help in managing the externalities. In all such cases, the arguments for regulators to assume the initiative are substantially less compelling than cases involving unsophisticated parties.

Competitive and Uncompetitive Markets

The extent to which a given product or service market is competitive provides another distinction for regulators. Information about such matters as typical price or interest rate ranges can be much more difficult to obtain in markets that lack close substitutes for the good or service being traded. Competition does not guarantee full disclosure of all information. However, informational asymmetries sometimes prove less important where many substitute products or services are actively traded because producing information in such markets may be a cost-effective way of competing for business — even if clients are relatively unsophisticated.

To specify a degree of competition correctly, one must accurately define the product or service market in question. The problem arises for both wholesale and retail markets because analyses of financial system performance do not always recognize clearly which financial products or services are substitutes and which are complements.

We define *substitute transactions* as those that represent the same function (or subfunction), while *complementary transactions* are functionally different activities. The definition of substitutes or complements cannot be approached through traditional descriptive classifications, but one theoretical way is to measure elasticity of substitution — that is, the responsiveness of supply or demand to changes in price. Substitute products or services have high elasticities of substitution; complements do not.

For example, for an investor, a Government of Canada treasury bill is a close substitute for a treasury bill issued by the City of Montreal. Neither of these bills is a close substitute for a venture investment. Indeed, a venture deal and a publicly traded security represent qualitatively different investment opportunities and are, therefore, complements rather than substitutes.

Governance of Financial Deals

The principal differences between types of financial deals are features that distinguish those appropriate for the arm's-length governance provided by market agents from those more suited to the non-arm's-length governance typically provided by financial intermediaries and financial conglomerates.

Any financial deal involves providing funds, managing risks, or a combination of the two. Moreover, any deal can be classified using only a few fundamental characteristics. For present purposes, it is useful to summarize these combinations as presenting either a standardized or a nonstandardized deal.

Standardized deals arise in such circumstances as financing acquisitions of relatively liquid assets, and are consummated under conditions of risk. They are most cost-effectively governed as market transactions, mainly because they do not require intensive monitoring on a continuing basis.

Nonstandardized deals often arise in financing acquisitions of relatively illiquid assets and are struck under qualitatively determined conditions that present uncertainty rather than risk. Nonstandardized deals are typically arranged through intermediaries or even within financial conglomerates because these institutions can exercise the monitoring and adjustment capabilities needed to bring the deals to a profitable conclusion. (*Adjustment* here means that the original terms of the deal may be amended in response to changes uncovered by monitoring.)

Standardized deals, whether they represent assets or liabilities, can be readily valued using market prices established by active trading. Nonstandardized deals are more difficult to evaluate. In the case of assets such as the portfolios created in bank lending, the financial institution typically decides to acquire them on the basis of privately generated information and holds them to maturity, rather than trading them. Valuing at least some nonstandardized liabilities, such as a pension fund's liabilities, can be equally difficult.

Trading produces public information about the value of standardized instruments. There is much less public information about the value of portfolios consisting mainly of nonstandardized instruments. Financial institutions value nonstandardized assets for their own purposes, but unless they subsequently trade a beneficial interest in those assets, the information is likely to remain private. (One way of trading beneficial interests is to break up securities into standardized and nonstandardized components; the former then trade. Securitization — the selling of a beneficial interest in a package of nonmarketable assets, rather than the individual assets on their own — is a case in point.)

Since the financial system performs its resource allocation role most effectively when information is widely and publicly available,[4] supervisory information should be disseminated whenever it proves cost effective to do so.

The assessment of cost effectiveness involves judging whether a change in information release might affect regulatory effectiveness. Situations in which the balance of factors suggests it would be desirable to disseminate more public information are identified later in the paper.

The most difficult governance issue relating to financial institutions is that some kinds of institutions, such as banks, assemble asset portfolios whose market values are difficult to establish, while other institutions, such as mutual funds, assemble asset portfolios whose market values are much more readily established. Still other institutions, such as insurance companies, present similar difficulties with respect to valuing their liability portfolios. These differences in function remain despite recent combinations of the different types of business.

Management of each portfolio type demands specialized skills, and it is not yet clear whether a management possessing one set of such skills can readily apply them to managing other types of portfolios. In particular, different kinds of portfolios present different kinds of management challenges, and different information systems are needed to meet these challenges.

Different kinds of portfolios also demand the application of different standards of capital and of liquidity. A clearer understanding of how the different risks combine to affect each other is also needed before analysts can claim to understand fully the governance issues affecting financial institutions' management and their regulators.

The Economics of Change

Economic considerations drive financial system change. Managements restructure firms with a view to securing new sources of revenue, new ways of reducing costs, or both. The formation of financial supermarkets, the growth of large international investment banks, and the mergers of financial institutions all represent attempts to increase profitability.

Technological change is currently driving *front office* as well as *back office* reorganization — that is, reorganization of services provided to clients as well as of behind-the-scenes accounting. The former is based on new product development; the latter mainly on new forms of transacting and data processing that have reduced demand for capacity expansion and have even created excess installed capacity. For example, the recent growth in electronic debit transactions has replaced previous continuing growth in paper transactions. The recent mergers of the data-processing departments of the large banks represent attempts to deal with excess capacity. It is likely that financial firms will also experiment with renting out data-processing facilities and using them, for example, to provide information to clients.

Changes in financial industry organization are driven by demand as well as by supply. For example, financial institutions continue to adapt to increasing *disintermediation*, a process in which both wholesale and retail clients have been replacing deposits with investments in marketable securities that promise higher expected rates of return (albeit with commensurate increase in risk). Partly in response, the financial industry is reducing its emphasis on its traditional intermediation business and increasingly offering new investment vehicles and investment advice, changes that are affecting both retail and corporate financial services.

Risk and Uncertainty in New Affiliations

New forms of business can present new risks and uncertainties that, in turn, present unfamiliar governance challenges. The new kind of business may not be wholly understood until a financier has been conducting it for some time, in part because some risks arise from not knowing how many competitors are likely to enter the business. For example, some institutions are still learning about the risks presented by their growing derivatives businesses.

New governance challenges face financial firms' clients as well as the firms themselves. For some time now, consumers have been moving deposits into riskier forms of investments, especially pooled funds, and this trend appears likely to continue for some time to come. Clearly, consumers are seeking higher returns. Perhaps they are willing to assume the commensurately higher risks, but perhaps they face those risks without fully understanding them. For example, few consumers realize that the pooled fund investments sold by banks do not generally carry consumer protection insurance. Even some fixed-term deposit instruments issued by bank affiliates do not offer deposit insurance.

Still less obviously, the incentives affecting the administration of pooled funds differ from those affecting the administration of bank deposits. Whether consumers are cognizant of these differences is unclear.

The lessons from the collapse of Barings Bank and from other losses in derivatives trading is not that financial innovation should be restricted nor that supervisory powers should be expanded substantially. Supervisors should, however, increase their efforts to encourage — and perhaps at times to require — financial firms to ensure the adequacy of their internal risk-management controls.

The increases in disclosure now being worked out by regulatory and industry committees concerned with derivatives trading will help to improve market transparency, as will increased exchanges of information between central banks and supervisory bodies in different countries. Financial institutions should face penalties for failing to act responsibly, whether the failure arises from taking direct action or from not ensuring proper oversight. Such penalties might also apply to regulatory authorities found insufficiently diligent in the discharge of their duties.

Change and Profitability

In a changing system, what appear to be *monopoly rents* — profits above competitive levels — can appear from time to time. Temporary profit increases do not, however, necessarily indicate uncompetitive market conditions; they may, indeed, reflect system adaptability. Financial firms can be expected to earn above-normal profits in certain disequilibrium situations, even in a competitive market, and that prospect is an important driver of financial system change. Change occurs as firms innovate, facing new risks or uncertainties as they search for new sources of revenue or new methods of cost reduction.

For example, firms may offer new products that, at least for a time, have no ready substitutes. Without the prospect of earning temporary rents on these new products, the incentives for innovation would be weaker. But so long as competing institutions are also free to offer the new product (after having learned how to emulate the innovative firm), the rents should be attenuated over time.

Organizational Structures

Understanding the determinants of financial firms' organizational structures helps the analyst to understand how these firms make their strategic decisions and, consequently, to develop a basis for assessing the financial industry's recommendations regarding structural change.

The Economics of Strategic Choice

Firms make strategic choices with a view to enhancing profitability. Many of the world's major financial institutions are multinational businesses with sizable research staffs and large international trading operations. These institutions make about half their revenue from net interest earnings, the other half from performing services. To compete effectively in international markets, such firms need to be well known for their financial strength, their expertise, and their probity.

Size, Cost, and Profit Functions

When financial institutions administer financial deals, they perform three principal governance functions: screening, monitoring, and adjustment. Each involves information processing, and each is likely to be characterized by scale economies, especially arising from spreading fixed (setup) costs over greater business volumes. Irrespective of the particular financial product or service involved, the three functions mainly use the same inputs; therefore, individual products' cost functions are likely to exhibit economies of scope as well as of scale.

Scale and scope economies are frequently cited as explaining the large and growing sizes of financial institutions, but there is actually little econometric evidence[5] that the bigger, multiproduct firms enjoy cost advantages over their smaller, more specialized counterparts. A recent summary of cost-function research in the United States and other countries suggests that "economies of scale may exist for banks in the $100 million to $5 billion range," but it offers no evidence of scale economies for larger institutions. Evidence of the existence of economies of scope is similarly weak. In addition, "studies of nonbank financial service firms such as thrifts, insurance companies, and securities firms almost always report neither economies of scale nor economies of scope."[6]

To the extent that benefits do stem from increasing size, they may well flow from greater revenue generation rather than from cost reduction. For example, large institutions may be able to enjoy economies of scope from introducing existing products in new areas or from offering new products in existing or new areas. That is, a financial firm may enjoy economies of scope on the revenue side, as well as on the cost side, of an operation. In confirmation, one study of banks' profit functions concludes that mergers are at least as strongly motivated by attempts to find sources of increased revenue as they are by attempts remove managerial inefficiencies.[7]

Profit-function studies are more inclusive than the more traditional analyses of cost functions, but even the former have not yet included all the harder- to-quantify factors that might explain the size of financial institutions. As Saunders speculates,

> [T]he real benefits to technological innovation may be long term and dynamic, related to the evolution of the US payments system away from cash and checks and toward electronic means of payment. Such benefits are difficult to pick up in traditional economy of scale and scope studies which are largely static and ignore the more dynamic aspects of efficiency gains.[8]

In addition, large institutions can probably diversify more fully than their smaller counterparts and thus obtain better risk-return tradeoffs than smaller institutions.

Finally, attempts such as that of the Royal Bank of Canada to acquire London Life contemplate the possibility of benefiting from cross selling and interorganizational use of information. The fact that the Royal Bank could not compete with a rival bid from an insurer suggests, however, that managerial experience is another factor. So long as firms continue to merge, the actions of their managements suggest that looking for operating economies is one explanatory factor, whether or not past studies have detected these operating economies.

On balance, economic factors drive financial intermediaries toward greater size, but an opposing force may exist. The increasing use of networks implies that the financial firm of the future may find it economic to use information processing that is more distributed than the present norm. The current weakening of the linkage between communication distance and its cost will likely give these developments further impetus. Indeed, coupled with marketing using electronic or other novel means of financial services delivery, the changing economics of communications may give small institutions advantages they do not now possess.

The importance of these factors for policy analysis is to suggest that financial institutions will probably continue to become larger, but that distributed information processing may enhance entry to what are now fragmented markets. Additional entry could mean that currently segmented markets will become more competitive in the future.

Economies of scope and scale cannot explain the observable cost differences among financial institutions of the same size. Research on this topic points to the importance of managerial capability as an explanatory factor. Studies of cost dispersion suggest that "cost inefficiencies related to managerial ability and other hard-to-quantify factors may better explain cost differences and operating cost efficiencies among financial firms than technology related investments per se."[9]

Regulatory Tradeoffs

Proposals for regulatory change almost always involve striking a balance between conflicting goals. Although no universal, objective standard exists for use in striking such balances, our economic analysis has some useful implications.

Before we present them, we must insist on two caveats. First, any balance between conflicting goals needs to be struck on the basis of judgment. Where possible, judgment should be supported by empirical findings, but in many instances the available evidence is sparse. Second, the circumstances in which tradeoffs arise differ enough to be considered case by case; so far as we know, there are no universal answers to many of the regulatory tradeoffs we address.

Overall, although no theoretical guide can to ensure that reaching individual judgments will lead to an optimal form of regulation, we think that consideration of our tradeoffs can usually improve the situations to which they are applied.

Does Competitiveness Create Prudential Concerns?

The efficiency of resource allocation is generally improved when firms performing the same function face a level playing field. Competition and innovation are both more likely to be stimulated when different firms can exercise the same business powers at essentially the same costs. In other words, if different institutions perform the same function, the legislation governing them should have roughly similar cost impacts, independent of the players' traditional identities.

If this level playing field principle conflicts with the aims of prudential regulation, however, it cannot be applied without qualification. How can policymakers best manage the tradeoff?

When Prudential Concerns Are Illusory

Before we discuss prudential regulation that is desirable, it is worth noting that compelling prudential concerns arise less frequently than is sometimes suggested. First, no strong economic arguments support the notion that prudential interests can generally be served by separating forms of business (the few exceptions are discussed below).

When different forms of business are combined (leveling the playing field), prudential concerns should be addressed mainly by ensuring that regulators have the resources and can obtain the information necessary to perform their assigned tasks. With resources and information, they can devise appropriate means of addressing the prudential concerns that arise from changing structures.

Second, prudential arguments for restricting competition do not always stand up to scrutiny. For instance, some observers recommend restricting competition to protect historically defined markets. (Recent examples are leasing and insurance.)

In addition to offering the separation argument of the previous paragraphs, these observers contend that small institutions better serve consumer interests. Some “small is better” proponents argue that smaller institutions cannot compete on a cost basis with their larger counterparts. But the argument that big institutions have a cost advantage over smaller ones implicitly recognizes that the distribution costs incurred by current arrangements exceed their competitively determined levels. It is clearly not in consumers’ interests to restrict competition and thereby keep costs high.

Our argument here is not that small institutions are unimportant. In some markets, niche players may indeed be able to provide more flexible and innovative services than their larger counterparts. If small institutions can perform services that larger institutions cannot and if consumers value these services, clients will pay higher prices willingly. Legislation to divide up the turf is not needed.

Prudential concerns are also sometimes invoked in efforts to ensure equality of outcomes. Yet, financial legislation should aim for equality of opportunity, not equality of outcomes. In the competitive evolutionary struggle, some firms are bound to face difficulties. If they are inefficient and cannot rectify their shortcomings, competition will ensure their failure or absorption. Either outcome is desirable from an efficiency standpoint.

To shelter inefficient firms, either by protection or by subsidy, is to impose unnecessary costs on consumers and to defer necessary system adjustments. So long as competition can be maintained, the public benefits from evolutionary struggles. For example, as already mentioned, if consumers value small, specialized firms, a competitive environment will stimulate their emergence, at least in the absence of other obstacles.

When Prudential Concerns Exist

Prudential concerns do need to be addressed in retail transactions, where individual consumers have substantially less expertise than the financiers with whom they deal. But such consumer protection need not restrict competition unduly. It may mean licensing or entry requirements, but astute regulators can try to ensure that these standards do not serve as barriers to entry.

As one example, incentive-compatible regulations that require agents to place clients’ interests above their own are probably necessary for maintaining continued consumer confidence, but they should not restrict new mutual funds from entering the business. As a second example, regulations should require trustees to avoid conflicts of interest when advising consumers about their investments, but that should not give some trustees advantages over others.

Legitimate prudential concerns may also arise at the wholesale level, but less frequently than in retail transactions (because sophisticated parties can usually look after their own interests). Wholesale transactions can sometimes be improved by standards that ensure cost-effective informational disclosure, but in most cases, industry practitioners are best placed to identify these circumstances.

A firm may sometimes suffer difficulty when a competitor fails; in such cases, the industry may request supervisory help to manage the externalities. For example, a case sometimes exists for extending emergency liquidity to surviving, solvent firms whose operations are affected by the sudden failure of a competitor. Consider, however, that the need for providing emergency liquidity could be lessened by proactive improvements in disclosure.

Do Asset Concentrations Reduce Competitiveness?

Despite the trend toward further increases in the total assets of financial groups, increased asset size does not necessarily imply decreases in competitiveness. For example, over the past decade Canada's banking industry has absorbed much of the trust and securities industries, but the latter businesses still appear to be competitive.

Insurance companies are also combining, as evidenced by the recent acquisition of North American Life by Manulife and the recent proposal of Great West Lifeco to acquire London Life. Again it appears that the remaining large firms compete actively with each other.

In any event, such effects are not peculiar to Canada. Currently, bank mergers are commonplace in both the United States and the United Kingdom. To cite just one example, last year Britain witnessed the merging of Lloyd's Bank and the Trustee Savings Bank, creating a financial firm with assets of just under US$240 billion. The banking and securities businesses are also combining in both these countries, albeit slowly in the case of the United States. Even there, the long-awaited removal of the 1933 *Glass-Steagall Act*'s prohibitions against combining banking and securities business once again appears likely.

Competitiveness

Economies of scale and scope are the principal factors explaining the emergence of large institutions, but the market presence of a small number of large firms should not be taken as *prima facie* evidence of reduced competitiveness.

Competitiveness depends on the availability of substitute products or services as well as the threat of potential entry (especially if monopoly rents are posted). With regard to substitutes in Canadian retail markets, the large banks almost always face competition from such institutions as credit unions and *caisses populaires*. With regard to potential entry, markets that can be served electronically face potential competition from institutions throughout the world, as the entry of ING Bank into Canada illustrates.

If asset concentrations did reduce competition, they would have to do so in particular markets. The effects might be higher-than-competitive prices or failure to offer a relatively broad and evolving spectrum of products. Admittedly, the degree of competitiveness in different markets is difficult to measure, but there may be more substitute products and services than zealous opponents of asset concentrations recognize.

For example, Canadian debates about the availability of small business finance usually focus on banks to the exclusion of substitute sources. But Schedule I and Schedule II banks are not the only firms that make small business loans; credit unions, leasing companies, term lenders, venture capital firms, and, most recently, US banks such as Wells Fargo also serve this market.

Moreover, whatever a market's degree of competitiveness at one point in time, it can change as the financial system restructures. Indeed, remedies based on a given assessment of competitiveness can become dated quickly, possibly even before they are implemented.

Some attempts to enhance market access may be intended to increase firms' market power, but in a competitive environment they cannot succeed (except perhaps temporarily until other firms catch up). In any event, attempts to gain market power are not the only reason for the current popularity of mergers and restructurings. Some organizational changes are intended to cut costs, some to increase firms' access to long-term funds, and some to generate the capital needed to capture some kinds of international business.

Throughout the world, the financial industry is working to reduce excess capacity resulting from technological change. The increasing productivity of computing and communications equipment has shifted the optimal labor-to-capital ratios in the industry; worldwide, it is showing declining total employment and increased demand for higher skills. Excess physical capacity for serving retail and corporate clients is emerging as the role of the branch office is diminished by increasingly popular alternative forms of delivery. In the future, those branches that remain open will have to market broader ranges of products if they are to remain economically viable units.

Competition in Canada

In Canadian domestic markets, the banks are by far the largest players. Yet in relation to the size of the economy, Canada's principal banks are about the same size as those in some other Western countries.

Moreover, current ownership limitations may actually work to reduce potential competition. The current legislative requirements prevent, say, a retail store from setting up a banking subsidiary — although, according to recent press reports,[10] that restriction is not inhibiting banks and grocery stores from entering some kinds of partnership arrangements.

In international markets, Canadian financial firms are relatively small players. Most of the institutions prominent in foreign exchange, derivatives, and securities trading on a worldwide basis are much larger than their Canadian counterparts. If Canadian financial firms were larger, they would likely be more successful and able to generate more export earnings for Canada.

Whatever the importance of Canadian banks' size in various markets, studies do not suggest that they can exercise oligopoly powers in any given market or group of markets. Studies at the industry level in the United States, Canada, and other countries[11] suggest that banking industry revenue is generated in contestable markets (those in which entry and exit are fairly easy). Contestability reduces the capability of intermediaries to exercise oligopoly power, even if they have large market shares.

Those industry studies examine relations between changes in factor costs and overall profitability, however, and thus do not address the possibility that some individual domestic markets may still be uncompetitive. Market studies suggest that this possibility cannot altogether be ruled out. Using time series data for individual Canadian markets over the 1982–93 period, Barry Scholnik finds evidence of increasing differentials between consumer and prime loans, as well as between a mortgage rate and a guaranteed investment certificate (GIC) rate of comparable term.[12]

These findings are perhaps best regarded as suggestive, rather than definitive. Increases in interest rate differentials can be caused by oligopolistic pricing, but they can also result from improved estimates of the costs of doing individual types of business. In recent years, large financial intermediaries have renewed their attempts to estimate these costs, and the changes in pricing may thus be based on improved methods of accounting for information-processing costs or of assessing asset risk in relation to the intermediary's overall portfolio.

Another body of work, although sometimes cited as important, is actually irrelevant to understanding the practices and implications of asset concentrations. This work includes studies suggesting that large banks may not fully meet the needs for financing small business.[13] Given the nature of banks' credit provision activities (short-term, low-risk lending, frequently secured by relatively liquid assets) and the nature of small businesses' financing demands (high-risk equity funding, which is most difficult and costly to obtain), such findings are unsurprising, but scarcely relevant to formulating regulatory policy.

Canada's largest source of short-term finance is not necessarily able to profit from providing every possible type of funding, and low-risk, short-term lenders are generally unlikely to profit from supplying high-risk equity financing. To urge banks to provide that financing anyway would be to urge distortion of the workings of the financial system. The problems of providing long-term, especially equity, finance to small business are real ones, but banks are not the intermediaries best suited to address these difficult problems.

Do Ownership Restrictions Affect Firm Performance?

Another possible concern for regulators is whether ownership restrictions affect firm performance. For example, concentrated share ownership can both reduce the liquidity of traded equity and increase the value of its voting rights. On the other hand, widely distributed share ownership can reduce the possibility of takeover bids and thus shelter entrenched management. These ownership impacts may register on the performance of either the industry or some firms in it.

At the industry level, the current ownership rule for Schedule I banks is strict: no single person may own more than 10 percent of the outstanding shares. This rule may lead management to behave less competitively than they would if they had to face real threats of takeover or of some investor's acquiring enough shares to affect their firm's policies.

The other side of the coin is that, if an entire industry, or a large segment of it, is owned by foreign shareholders, those investors might act to the detriment of the nation's interests. For example, in times of institutional difficulty, some observers worry that foreign owners may limit lending to the detriment of the domestic economy. This fear may not be realistic so long as there are competing institutions serving the same markets.

At the firm level, the possibility of taking over the firm could prove a strong motivator to its management. But takeovers could also mean that, by creating new combinations of activities, a financial group might create new forms of business risk. Moreover, a closely controlled parent firm might misallocate funds (raised, say, through deposits) to serve the narrow interests of the control group at the expense of other shareholders. These potential problems must be recognized by regulators, who need adequate resources if they are to supervise effectively.

Legislative Reform

Our overwhelming impression of Canada's financial system is that it provides high-quality financial services at low cost compared with the rest of the world, but regulatory revision could improve performance in several areas.

Overall, we believe that legislative reform should encourage competitiveness and use the minimum amount of intervention needed to achieve the task at hand. We also believe that reform should attempt to bring functionally similar deals under a common legislative umbrella. Since working to attain these ends can pose difficult tradeoffs, regulatory goals sometimes have to be balanced judiciously, as already noted.

Thus, this section of the paper first examines the objectives of regulatory revision and then addresses, in turn, specific matters for possible revision: industry functions, ownership forms, prudential regulation, and information release. Specifically, we identify several inappropriate constraints — such as limits to the kinds of institutions permitted to provide services — and advocate their removal. We also find instances of perverse management incentives, which need restructuring. Finally, we identify some instances of insufficient disclosure and recommend additional information release.

Objectives

The theory of the previous section implies that any proposed regulatory change should offer at least a reasonable promise of securing net economic benefits. This section examines the list of objectives laid out in the working report of the Task Force on Financial Services.[14] We use the theory to argue that some of those objectives are proper matters for regulation, while others fall outside its purview.

Although much of our focus is necessarily on financial institutions and other big business, we do not forget the needs of ordinary Canadians, particularly in the matter of managed funds, in which household investment has increased hugely over the past decade.

Managed funds are subject to less stringent regulations than bank deposits. Standards for uniform measurement and reporting of performance are still missing, especially after adjusting for risk. The entire mutual fund industry lacks governing regulation: there are no minimum standards for portfolio solvency or management conduct. Important proportions of households' assets are also held in pension funds, where regulation is similarly underdeveloped.

To the extent that these managed funds are invested in marketable securities, supervising them presents somewhat different problems than does supervising financial intermediaries with largely illiquid asset portfolios.

Regulatory Jurisdictions

Before launching into our analysis, we need to re-emphasize our lack of interest in matters of jurisdiction. The regulatory framework needed to achieve the goals of improved resource allocation and confidence in the financial system cannot be divided up efficiently using the traditional federal-provincial dichotomy based on traditionally defined industries. Thus, we advocate reform where we expect it to improve financial system functioning, irrespective of whether the legislation would be federal, provincial, or both. This approach, we believe, ultimately will prove more useful than would a narrower discussion of, say, federal regulation of financial intermediation.

Indeed, jurisdictional quarrels can distort resource allocation. One of the most egregious examples is the provinces' retention of powers to control securities legislation. Much of the securities business is now international, and it is conducted by either national or international firms. Regulation of this business at the provincial level is an anachronism, adding to the costs of issuing securities, fragmenting markets to some extent, and otherwise reducing the credibility of the Canadian securities business.[15] One price of catering to this form of provincial parochialism is loss of business to other countries, chiefly the United States.

Moreover, some of the objections to forming a national securities commission do not stand up to scrutiny. Such a commission would not prevent a province from giving different treatment to securities issues marketed only within its borders. To argue that a national commission would take business away from a province is, in effect, to recognize the need for a more comprehensive regulatory umbrella than now exists.

If some provinces believe their special interests could best be served by provincial commissions, they could continue operating their existing commissions as adjuncts to the national commission. If those commissions could not compete with a national body, business would be sending a message about the kind of regulation it finds most cost effective, and that message should not be ignored.

Regulatory Objectives

Despite our generally favorable view of the Canadian financial system and its regulation, we suggest some changes to the existing regime so long as one or more of the following criteria are satisfied:

- prudential concerns seem to be compelling;
- additional disclosure appears to be cost effective;
- self-regulation does not seem to offer a realistic promise of correcting current gaps in regulation.

Protecting Consumers

Theory suggests that retail transactions should generally be subject to more stringent disclosure standards than wholesale transactions among sophisticated counterparties, largely because the former are conducted between firms and unsophisticated consumers, while the latter involve parties who are equally sophisticated.

Some proponents of change obscure this distinction to the disadvantage of the unsophisticated. For example, proposals that pretend that the individual depositor is as sophisticated as bank analysts or the Canada Deposit Insurance Corporation (CDIC) are clearly counsels of perfection that could place consumers at serious disadvantage.

Several kinds of retail transactions merit additional regulatory attention.

Mutual Funds. Present disclosure law and practice regarding mutual funds are clearly insufficient, as documented in the Stromberg Report.[16] The principal objectives of more stringent regulation of managed funds are better consumer information and protection against business practices that could harm the mutual fund industry itself over the longer term.

For example, agents should be subject to conflict-of-interest legislation. Some agents selling pooled funds receive commissions, while others do not. In addition, some managers of pooled funds trade both for their clients and on their own account, a situation that clearly presents a conflict between their own interests and those of the clients.

Some observers favor self-regulation, rather than strengthening governmental supervision. The main argument in favor of self-regulation is its sensitivity to industry concerns. That very sensitivity is, however, the main disadvantage of self-regulation: industry may apply its rules to the disadvantage of its clients. The effectiveness of self-regulation depends in considerable measure on whether all firms in the self-regulated industry have reputations that they wish to protect over the longer term. In such cases, financiers are likely to keep client interests prominently in mind, recognizing that the industry will prosper if it treats clients honestly and efficiently.

A common system of risk-adjusted performance ratings is needed so that consumers can readily compare returns on different forms of investment. All managed funds should also declare, on a uniform basis, the sizes of their administrative costs and agent commissions, again to enhance comparisons. Every effort should be made to ensure that consumers understand that most types of pooled funds can offer no guarantee of final value. Provincial securities commissions and securities industry representatives are now addressing these questions; further analysis should probably await their recommendations.

Although additional regulation clearly would increase industry costs, we regard some such costs as justifiable on prudential grounds and for the long-run good of the industry.

Pension Funds. Pension funds also require further regulation. The current disclosure of funding status and portfolio quality is clearly insufficient, and a performance-rating system should be put in place. The nature of the fund (defined contribution or defined benefit) needs to be explained clearly to the beneficiary.

A rescue fund of some sort would be desirable, but it should avoid the perverse incentives problem of level-premium deposit insurance. If the private sector does not find it profitable to operate such a liability insurance scheme, the public sector might have to do so — perhaps by extending the default insurance now offered by Ontario, which covers beneficiaries in the event of a fund bankruptcy.

The Senate Banking Committee is now addressing questions of pension fund administration; further recommendations for change should await analysis of its recommendations.

Notwithstanding the foregoing, neither pension funds nor other funds entitled to tax advantages should be restricted as to their percentage of foreign investment. Such a provision interferes with resource allocation and limits managerial discretion, to the detriment of the fund's beneficiaries.

Deposit Insurance. Given the unequal sophistication of consumers and financial intermediaries, we advocate continuation of insurance for funds placed in a regular deposit-taking institution. Coverage should be full for amounts up to $60,000 for each individual's dealings with a given financial institution, rather than for each $60,000 account as is now the case. (The limitation would provide depositors with added incentives to assess institutional risk and possibly to diversify their deposits among institutions.) Retail clients should have readily available, clear statements of what kinds of accounts are covered and to what extent.

We regard risk-adjusted insurance premiums as a useful incentive for prudent management but recognize that, in some cases, increasing premiums might not be sufficient. Public disclosure of the premium rates paid would provide a further incentive, as would public disclosure of how regulators have rated the quality of an institution's asset portfolio.

Serving National Objectives

Can financial regulation serve national priorities? Only sometimes, and in some instances the best methods of pursuing these priorities are not those of imposing more regulation.

Job Creation and Economic Growth. Through competitively seeking profits, the financial system funds economic growth and, in doing so, provides new jobs. Since the profit motive provides a strong reason to seek viable growth opportunities, the financial system normally needs no other incentives to perform its resource allocation tasks. Government should not restrict the workings of competition unless the tradeoff for doing so is compelling. (Such tradeoffs occur rarely.)

The job of financial firms in the private sector is to maximize their long-run profits, but the interpretation of profitability need not be narrow. People do not always recognize that economic rationality and humane business decisions can coincide to some extent. To maximize profits, each financial firm needs to recognize its dependence on stakeholders other than its owners and the value of behaving responsibly toward them. For example, firms that resort to layoffs without much regard to employee morale may be imposing long-run costs on themselves.

The coincidence of economic rationality and humane business decisions is not perfect, however, and firms are economic entities that have a responsibility to observe economic performance criteria. Societal goals such as employment creation and income equality are external to the private firm's calculations. Doing more to attain them may well be socially desirable, but their pursuit is the responsibility of government, not the financial system.

This social / private split is not absolute, however. As we consider later, some people believe Canadian banks benefit from safety net provisions. Moreover, government initiatives are financed by taxation, and its impact ultimately must be comparable to that of other nations if Canada's financial business is not to be affected adversely.

Competition, Efficiency, and Innovation. As already noted, our review convinces us that Canada's financial system generally operates competitively, although some local markets may not appear to be well served. When such instances arise, the first question to be asked is whether the market is insufficiently profitable. The financial system cannot be expected to enter unprofitable markets willingly or to compete vigorously for unprofitable business.

Some such situations can, however, be remedied. The most important situations are those in which industry representatives have successfully limited competition through dividing up business or using restrictive codes of practice, constraints that limit innovation and financial restructuring.

Full Advantage of Technological Advances. The expectation of increased revenues or reduced costs drives technological change. The private financial sector will adopt new technology quickly whenever it sees profit to doing so. More regulation cannot facilitate this process nor can it effectively direct the form of technological development.

The main task of regulation here is to avoid rules that might impede technological change by presenting costly obstacles to conducting business in new ways. The most serious current barriers are rules preventing institutions from entering each others' businesses, but antitrust concerns regarding data-processing networks may also have some inhibiting effect on profitability calculations.

In the future, problems of framing new rules will likely arise in Internet commerce. Again the principal issue will be to devise regulations without impeding the pace of technological change.

We reiterate here that temporary monopoly rents are a strong driving force for technological change. Those above-normal profits should not long persist in a competitive financial environment. Nevertheless, policymakers should recognize that the very possibility of temporary rents can serve to encourage dynamic adjustment. A competitive environment in which financial institutions' size, operations, or profits are artificially limited offers less incentive for technological advance.

International Competitiveness. Financial institutions' own profitability calculations usually discourage them from taking on unprofitable business, whether domestic or international. (Managements do err occasionally, and the nature of risk-taking means that even the best sometimes suffer losses. But regulators and politicians possess no special expertise to second-guess the appropriateness of management decisions.) To the extent managements are clearheaded about likely profitability, there is little danger of a conflict between an internationally competitive system and strong, vibrant domestic institutions.

Nevertheless, a strong emphasis on international financial business may pose some externalities for domestic business. First, an institution working hard to develop an international presence may pay less attention to developing marginally profitable domestic markets. This emphasis should not, however, pose serious difficulties in a competitive domestic environment, where specialized institutions can spring up to take advantage of the unavailed profit opportunities.

Second, an institution taking on highly risky international business may try to charge any resulting losses against domestic activities. In a competitive market, attempts to pass on higher costs result in loss of business, but not every market is equally competitive. Regulators should try to discourage any noncompetitive practices they perceive. Public disclosure of identified noncompetitive practices could prove an effective deterrent.

The Best Interests of Canadian Businesses and Consumers. A competitive financial system will serve its clients well if it expects to profit from their business. In most instances, the profit motive alone should be sufficient to stimulate the necessary attention, particularly if regulators are assiduous in removing artificial barriers to entry. If the system does not foresee profit in a particular market and if serving that market is deemed a desirable public policy objective, then financial institutions need to be provided incentives to carry out the task.

For example, private financial institutions should not be expected to offer unprofitable development loans unless they are provided with a subsidy to help them turn a profit on this kind of business.

The Safety Net Issue. Some commentators argue that the value of banking industry is enhanced by the provision of a government safety net that includes CDIC insurance coverage, liquidity support from the Bank of Canada, access to the payments system,[17] and possibly a "too-big-to-fail" doctrine. If these provisions actually do increase the value of the industry, a case might be made for achieving certain social goals by imposing commensurate costs on the industry. We have no quantitative evidence regarding these issues, but we can offer some qualitative arguments about them.

First, we do not know how to evaluate the claim that policy embraces a too-big-to-fail doctrine, in part because the rescue of any failing firm depends on decisions made by the government of the day. We do know that the banking system has absorbed weaker institutions in the past, and an historical analysis of who bore the costs might be informative.

Second, CDIC insurance coverage is provided in exchange for premium payments. We have not seen any studies of whether those premiums are set at economic levels, but carrying out such studies would be one way to assess whether deposit insurance somehow subsidizes the banks. At least some managements regard deposit insurance premiums as burdensome costs.

Third, liquidity support from the Bank of Canada is intended to help solvent but illiquid institutions for the benefit of the financial system as a whole. It is not clear to us that such attempts at externality management convey any undue advantages to the industry or its members.

Finally, the Canadian Payments System (CPS) is largely a creation of the banking system, formed from a private system without payment of compensation to the banks.

On balance, we regard the arguments of special privilege for the banking industry as weak ones but acknowledge that our conclusions are open to further evidence.

Responding to Community Issues

Many people charge that financial institutions, particularly banks, are not sufficiently responsive to community needs. Yet the presence of competing institutions (*caisses populaires*, credit unions, mutual funds) means substitutes exist for both loan and deposit products, and the availability of substitutes calls into question the charges' validity. If a market is potentially profitable but is not being served, competitive institutions will detect the opportunity before long.

The explosive growth of mutual funds and the entry into Canada of electronic banks are clear evidence of the system's responsiveness to perceived profit opportunities. The decision of regulators to permit competition from Wells Fargo, an institution with no physical presence, is a welcome move in the direction of providing further competition in one area (small business finance) where competition may have been less than vigorous in the past.

Regulators and policymakers should be concerned with competitive, prudent operation of the financial system. All means cannot, however, be employed equally effectively in the attainment of desirable ends, and social policy objectives, however laudable and desirable, should be approached through mechanisms other than financial regulation.

For example, if low-income consumers are not good credit risks, financial institutions should not be compelled to lend to them. To require institutions to make such loans would be to confuse the goals of efficient financial system operation with policies for income redistribution (in this case, from shareholders to low-income persons presenting poor credit risks).

None of the foregoing should be taken to mean that it is acceptable for any financial institution to use its expertise to harm consumers who cannot reasonably be expected to be as well informed as the institution itself. In the case of differing degrees of business ability, the onus is on the sophisticated party to explain transactions in such a way that the less sophisticated party is capable of assessing where his or her self-interest lies.

Industry Functions

Are Canada's financial businesses subject to restrictions whose effect is to treat similar functions differently? The question arises in several regards: different kinds of financial institutions that engage in (or want to engage in) the same kind of business; wholesale and retail transactions; and access to payments systems.

Equality of Treatment

Banks are currently limited in their ability to offer insurance products, an anticompetitive limitation that should be removed. And nor should banks be prevented from offering leases. Both these restrictions interfere with resource allocation and keep consumer prices higher than they would otherwise be.

On the other hand, some new prudential concerns may arise as financial firms enter new businesses. For example, if banks are to offer insurance products as a part of their regular product lines, they should be subject to the same prudential controls as insurance companies. Similarly, if insurance companies want to offer chequable deposit services, they should be subject to the same prudential controls as other depository intermediaries. (Canadian insurance companies have not generally had ready access to the payments system, but the situation was changed by a 1996 consent order and may be changed further through the recommendations of a task force now under way.)

Capital corporations (lending intermediaries) are now treated differently from banks conducting the same kind of business. If a firm such as GE Capital or Newcourt Financial is best organized as a capital corporation, other financial institutions should be able to organize competing subsidiaries under the same legislation. Nevertheless, regulators must be able to manage any prudential concerns that might arise from the operation of financial corporations organized as, say, bank subsidiaries.

An issue that might also arise is the minimum amount of capital resources that a combined enterprise should maintain. If a bank now requires substantially less capital to form an insurance subsidiary than a similarly capitalized insurance company does to form a depository intermediary and if the amount and composition of the firms' business is otherwise comparable, competition between the two is unequal. The same minimum amount of capital should be required, regardless of whether the parent company is a bank or an insurance company.

Wholesale versus Retail Transactions

Wholesale financial institutions that deal principally with sophisticated counterparties could be exempt from many of the regulations applying to retail institutions. In wholesale transactions, prudential concerns can be addressed mainly by the negotiating parties, since they are all highly likely to be sophisticated business persons.

Similarly, problems of informational asymmetry do not plague wholesale transactions to the same extent as they do their retail counterparts because sophisticated parties can develop means of removing or ameliorating the inequalities. Thus, regulation of wholesale firms probably needs to go little further than a statement of the principles they are expected to follow.

A possible side effect of a noninterventionist approach is that an institutional failure might create a loss of confidence. On the other hand, since closely regulated institutions have also been known to fail, any link between a noninterventionist regulatory stance and possible insolvency is at least partly illusory.

Retail transactions are a different matter because institutions can raise substantial amounts of funds from retail customers, who are typically not well informed about the default risks of the institutions with which they deal. Consumer protection plans, such as deposit insurance, are mainly justifiable on the grounds that it is unrealistic to expect consumers to be as fully informed as are sophisticated businesses and that the quantity of services consumers demand may be increased by reducing their costs of credit investigation and information processing.

Payments System Issues

Access to the payments system can be an important determinant of competitive ability. The debate on access is enhanced by distinguishing two payments system functions: (1) clearing and settling payments, and (2) facilitating access to deposits used as a store of wealth.

The two functions are currently performed by a combination of public and private sector organizations. The Canadian Payments Association (CPA) is essentially a public facility that controls and operates the CPS. While the CPS is still needed to effect final settlements, Interac — the private sector network — is effecting an increasing proportion of the electronic forms of payments system transactions. As the Interac Association notes, "[s]ince the late 1980s, the volume of paper-based instruments has stagnated while electronic payment methods have recorded steady growth."[18] In 1997, retail debit card transactions continued to grow at a phenomenal rate.

Interac. Interac's increasing prominence could imply a lessening of competition if some kinds of financial firms cannot obtain access to the network. New classes of firms' obtaining access might, however, pose new and different risks. Moreover, the original Interac members are entrepreneurs who have created an economically valuable entity and are entitled to obtain a fair return on their investment. Thus, anyone contemplating changes to Interac's current arrangements must address three separate concerns.

With regard to competition, only members of the CPA could join the Interac Association before December 1996. Now other parties, such as retail stores, are permitted access to Interac facilities through such means as linking their own terminals to the network. With retailers installing machines linked to Interac, the cost of providing connections will likely fall and accessibility to the payments system increase.

With regard to risks, the issue is not whether the client making a transfer has funds (Interac permits ready verification of balances). Rather, the institutions currently holding transferable deposits are widely regarded as sound and as having equally sound management. Should a depository institution fail suddenly, confidence in the payments system and ultimately in the financial system's functioning as a repository of wealth could be impaired. To offset these possibilities, CPA membership should continue to be limited to depository intermediaries that meet the Interac Association's current membership restrictions. This provision, in the interests of safety and soundness, might limit some firms' ability to compete for depository intermediary business, but to us the benefits of the restriction would exceed the costs.

To illustrate, if a large insurance company set up a banking institution, it could qualify for CPA membership under the current rules and offer transferable deposits just as other depository intermediaries do now. On the other hand, a small, closely held investment fund might not qualify for CPA membership and would have to negotiate with a member of that association to arrange for any withdrawal of its funds through Interac machines. Making clear the difference between CPA members and other institutions could help to reduce the public's information-gathering costs and enhance its confidence. It might eventually prove to be in Interac's own interest to develop some system of rating the financial soundness of different classes of intermediaries to which funds might be entrusted through use of the network.

With regard to the return on investment, one way of ensuring that the original owners of Interac receive a fair return would be to set up a corporation — call it Interac Corporation for the purposes of this discussion — with shares owned by those original developers. Interac Corporation would generate revenues from charging access fees to network users, and the net profits would provide the shareholders with a return to their invested capital. Equal access to the network could then be implemented by imposing the same access fee schedule on all users — original developers or new entrants.

The Internet. The Internet constitutes another possible means of effecting payments. This worldwide computer communications network currently facilitates comparison shopping. In the future, it is likely to be used more heavily, both to order goods and to make payments by credit or possibly by debit card. Indeed, it may well become one of the more important parts of the payments system of the future.

A rating system would offer the same advantages here as for Interac. Eventually, institutions doing business on the Internet may decide to establish their reputability with a rating agency, in much the same way as instruments traded on, say, an options exchange now carry a clearinghouse guarantee. It seems likely that at least some reputable institutions would find it profitable to institute this self-regulatory function. Some progress has already been made in establishing the idea of a trusted third party to administer credit card purchases over the Internet.

Ownership

Existing ownership and structural regulations aimed at meeting competition and other policy objectives are another important area for legislative reform. If a particular institution can do business under more than one set of regulations, it should be allowed to choose the jurisdiction it prefers. Such choices would provide information about how financial companies trade off competitive capability against prudential considerations. With this knowledge, regulators could decide whether the tradeoffs being selected merit supervisory intervention.

Equity Investments

The 10 percent share ownership restriction applying to banks and some other intermediaries is intended to ensure that large institutions will be widely held and to limit financial-commercial linkages. In many circumstances, both these ends may impose more disadvantages than advantages.

Upstream Applications. The principal advantage to maintaining widely held institutions is that no single group can gain control over the funds raised through issuing deposits. On the other hand, as we pointed out earlier, since the 10 percent limitation inhibits anyone's gaining effective control of an institution, it can contribute to the possibility of entrenched management and thereby impede the efficiency of resource allocation. The possibility of purchasing effective control could present management with efficiency incentives and improve the share prices of target companies.

Difficulties might arise if foreign investors acquired effective control over the entire financial services industry. Rightly or wrongly, many developed countries believe they can best meet their economic policy goals and regulatory concerns by retaining a degree of domestic control over their financial systems. Thus, political imperatives probably argue for retaining Canadian ownership of some proportion of the country's financial activity.

We think, however, that the disadvantages of the current system outweigh the advantages and that the market for effective control should be improved. Thus, we advocate relaxing the 10 percent limitation over the long term.[19]

Permitting Canadian financial firms to restructure before that limitation is relaxed could be advantageous, although a distinction between domestic and foreign acquisitions might be hard to maintain under the provisions of the North American Free Trade Agreement or the World Trade Organization.

If the 10 percent limitation is to be relaxed, the question of obtaining ministerial approval of an acquisition also arises. Ministerial discretion should only come into play when there is a compelling case that a proposed business change will create effects of national importance — a situation that might arise if majority ownership of the entire financial industry were likely to fall into foreign hands.

The extent to which Canada should pursue political imperatives is beyond the scope of this *Commentary*, but we think it appropriate to note that allowing political purposes to dictate the system's industrial organization has its own costs. Pursuit of political goals can lead to supporting uncompetitive institutions and even, in extreme cases, to weakening the system. Thus, as a general matter, we believe ministerial discretion should be exercised very infrequently. Transactions at junior levels should be dealt with through standard forms of regulatory approval or disapproval, rather than through ministerial pronouncements.

Downstream Applications. The 10 percent rule now prevents financial institutions from setting up certain kinds of useful affiliates, such as capital corporations. These restrictions do not now appear to perform a useful function. Thus, we think that, on balance, economics argues for their removal.

Current legislation does not formally prevent the sale of particular functions performed by a given institution, but, as a practical matter, ministerial consent is needed before a sale can be effected. Since the need to obtain that consent may be viewed as an obstacle to certain forms of restructuring, it might be worthwhile for the Finance minister to issue a policy statement regarding the terms on which such consent would likely be granted.

Commercial-financial linkages have been discouraged primarily on the grounds of limiting corporate concentration. The possibility that concentrations create disadvantages has not been clearly established, however, and limits to such links may restrict the efficiency of resource allocation.

A huge literature now compares the German and Japanese financial systems (which permit commercial links) with the US, UK, and Canadian systems (which generally discourage these links). The literature reaches no firm conclusions regarding the systems' comparative merits.[20] Nevertheless, our theory implies that permitting closer links with nonfinancial institutions might lead to the provision of more patient capital — capital invested with a view to relatively long-run payoffs — than is available in a market-oriented economy.

Although there appear to be no compelling economic reasons for generally limiting financial-commercial linkages, through either legislation or moral suasion, such links may have to be monitored both for prudential reasons and to ensure appropriate forms of information release.

Monitoring is particularly important when the financial institution in question is closely held. The incentives for self-dealing can be compelling in some small, closely held depository intermediaries. Their principal owners frequently succumb to the temptation to divert insured deposits to serve their own purposes, dominating the boards of their financial companies and ignoring standards of prudent lending while doing so.

Although having small, closely held intermediaries serve certain markets may be desirable, the dangers these institutions present mean they merit much closer supervision than larger, more widely held intermediaries. Special legislation may be unnecessary, but supervisors should concentrate attention on closely held institutions because problems have frequently arisen with them.

Changing Structures

Restructuring Canada's financial institutions will almost certainly raise several regulatory questions.

Organization. Should the parent company of a combined financial entity be a holding company (the US model) or an insurance company (a variant of the UK model in which the bank is the parent company[21])? No strong economic arguments generally favor one kind of structure over another. A holding company model would permit firms to enter markets more freely than is now possible, allow a firm to adapt its businesses more freely, and address some of the previously raised concerns regarding ownership. It might also be able, in some cases, to provide more patient capital (non-arm's-length investment) than is now possible.

Possible negative side effects could include uncertainty about the amount of capital required to satisfy the tradeoff between competitive and prudential concerns and difficulties in supervising the risk of the combined entity. Moreover, very large concentrations might be able to exert political power and thereby affect the nature of the regulations to which they were subject.

The minimum kind of intervention needed to control holding companies is statements of principle regarding prudential concerns, non-arm's-length investments, and possible conflicts of interest.

New Risks. As financial institutions enter new businesses and merge to form new kinds of business combinations, they may inadvertently alter their business risks in ways they do not immediately understand.

First, they may assume risks with which they are unfamiliar. A banker, for example, is not aware of all the risks of operating a large insurance company. In particular, new entrants to the property and casualty business quite frequently underprice insurance liabilities because they do not realize such claims typically have a "long tail" — that is, an increase over their originally calculated magnitudes, a propensity often underestimated with inexperience.

Second, a new business combination may present risk interactions that the previously independent companies did not face. For example, the risks of losses in the combined entity may be positively correlated and its total capital insufficient to cover the interactions.

Third, managerial resources may be insufficient to manage a combination of unfavorable events. For example, would the head of a new banking-insurance combination be able deal assuredly with difficult conditions in both the banking and insurance businesses at the same time?

Finally, regulators need to consider the implications of new business combinations for insuring agencies. For example, if aspects of a combined entity concerned both Compcorp (the insurance industry's insurer for policyholders if a company fails) and the CDIC, how would the agencies share information, responsibilities, and liabilities?

Different Regulations? Should new or restructured financial firms be subject to the same regulatory legislation? Functional analysis suggests a similarity between financial intermediaries, life insurance companies, and fire and casualty insurance companies. All hold funds on behalf of the public, and all facilitate risk trading in one way or another. That is, despite industry representations to the contrary, property and casualty insurance companies perform the same financial functions — intermediation (when they invest premiums), portfolio management, and the underwriting and trading of risks — as do other regulated financial institutions.

The advent of such instruments as catastrophe futures strengthens the case that the property and casualty insurance business is a financial business. Currently, property and casualty firms differ only in being somewhat more specialized than the banks and life and health insurance companies. In the future, property and casualty insurance companies may well be combined with other forms of financial institutions. For all these reasons, retail property and casualty companies should be guided by the same legislation as other financial intermediaries.

A case can be made, however, that reinsurance companies are wholesale firms and should not be governed by the regulations that apply principally to retail firms.

Narrow Banks. The principle of permitting *narrow banks* — those that collect deposits and invest the proceeds in, say, government bonds — to open for business does not appear to need any special legislation. Such banks presumably could qualify for deposit insurance; indeed, they ought to be able to argue that, because of the low risk they present, their rates for insurance should be lower than those for, say, full-service banks.

On the other hand, restricting deposit insurance to narrow banks would not serve the public interest. Such a policy would be tantamount to dictating the form of portfolio that a financial institution should choose, rather than requiring it to pay risk-adjusted premiums for the insurance it purchases.

Foreign and Electronic Institutions. Practices such as keeping out trading by Reuters may be in the short-run interests of the Toronto Stock Exchange, but they are not in the long-run interests of the Canadian business community. Wherever parochial and short-term interests are served — whether by legislation, practice, or industry codes — regulators should work toward achieving a better recognition of the long-term interest. Canadian financial history is all too replete with instances of protective stances that later worked to the country's detriment as technology and business practice advanced despite efforts to carve out protected markets.

Regulators must also remain aware that an institution can now assume commercial importance without having a physical presence in a country. The test of whether a business should be subject to a country's regulatory requirements involves the terms on which it sells its services or products via electronic commerce. For example, an institution whose communications state clearly to all users that it is doing business under US law would not normally fall under Canadian regulatory requirements. (At the same time, it would probably be wise for such an institution to urge its Canadian clients to seek legal advice on material transactions.)

On the other hand, an institution representing itself as Canadian is normally governed by the body of Canadian law appropriate to its type of business. If a firm warrants, either explicitly or by implication, that it is conducting business under Canadian law — say, through offering a CDIC guarantee — then Canadian regulators should obviously be required to supervise the operation.

An overriding consideration involves cases of suspected fraud. A fraudulent operator carrying out Internet business under the laws of a lax jurisdiction should at least be subject to cease and desist orders imposed by the countries to which that operator has Internet access and in which it is operating. In the case of deliberate fraud, the warrant in the previous paragraph would be insufficient.

Prudential Regulation

What sort of prudential regulation should be imposed on a combined business organization that engages in some activities that require close prudential supervision and others that do not? Subjecting some institutions to prudential regulation could place them at a competitive disadvantage if they also offer products or services that do not merit the same restrictions. For example, there appears to be no compelling reason to regulate capital corporations in the same fashion as retail financial institutions.

The practical issue is whether the different functions are actually unrelated from a prudential point of view. If the affiliated operations could affect the parent's solvency, considerations of moral hazard could arise.

Consider a bank that is permitted to split off some of its wholesale lending business. If the affiliate's operation created no prudential concerns, assessment of the alternatives' costs and benefits could be left to the bank's management. The situation would differ, however, if the lending affiliate's operations affected the solvency risk of the parent. Then the group's transactions with the risky affiliate would have to be monitored by the agency charged with looking after the prudential concerns.

If the parent's risks were higher than those of other insured intermediaries, the combined entity should expect to pay higher insurance premiums. In other instances, the operation of a risky affiliate might be a reason for requiring an entity to hold a higher proportion of capital than would otherwise be expected. In still other instances, the operation of the affiliate might be judged so risky that the CDIC would not offer insurance coverage to the combined entity.

Prudential concerns also assume importance in some retail transactions. As we have noted several times, unsophisticated householders cannot be expected to have either the same transaction information or the same knowledge as sophisticated financiers. In recognition of these informational asymmetries, Canada now has a patchwork of different forms of rating and compensation arrangements.

This system combines different standards of consumer protection and creates various forms of confusion. There is a question of how best to increase consumer awareness both of product differences and the provision of insurance. Some consumers do not well understand the functions of the CDIC, and still fewer are familiar with the operations of CompCorp and the Securities Industry Protection Corporation. Most mutual fund investments sold by banks are not insured, and neither are the time deposits sold by banks' affiliates. Some RRSPs are held in guaranteed funds that are insured by CompCorp, and some private sector pension funds have no default insurance protection.

Possible remedies depend on policymakers' deciding whether deposit insurance coverage ought to be strengthened or weakened in scope or coverage. If deposit insurance schemes are weakened — say, through co-insurance — the need for better consumer information becomes compelling. If federal deposit insurance is phased out, a number of private companies may spring up to offer rating information, insurance coverage, or both.

If, on the other hand, deposit insurance is continued in any form, as we believe desirable, the evenness of coverage by the various insuring agencies will become an issue, particularly if different agencies cover such substitute products as chequable deposits. If deposit insurance schemes are extended or strengthened in scope, the need for risk-adjusted premiums is compelling, in order to ensure that financial institutions do not face perverse incentives. Since private sector insurance against pension fund default is probably not available, it might be wise to extend the kind of protection now offered in Ontario.

Even though consumers are comparatively unable to evaluate portfolios of nonstandardized assets, they should be given incentives to place their funds carefully. First, they should be able to determine immediately if a given financial product is insured. Any liabilities issued by insured institutions should be clearly and prominently marked to indicate whether they are covered by CDIC insurance.

Second, CDIC coverage should be more sharply limited. Single consumers can effectively double the current $60,000 cap because it can apply to both their deposit and investment accounts.[22] As already noted, we favor a total cap of $60,000 for all the insured funds that a given client places with an institutional group, whether in single or in joint accounts. This capping would provide consumers with a marginally greater incentive to diversify, although it would not give them an incentive to screen financial institutions' different risks.

Information Release

Improvements in information dissemination can improve both resource allocation and risk-bearing. Markets work most efficiently when competitive trading takes place between equally well-informed parties, and risk-bearing is improved if all concerned parties have access to information regarding the risks.

Financial intermediaries acquire illiquid assets about which there is little public information, and it is worthwhile to ask whether disseminating available information about illiquid portfolios might improve system functioning. While we recognize that proposals for greater information dissemination must meet tests of cost effectiveness, we also believe that regulators could improve current disclosure practices.

Insofar as retail transactions are concerned, an area of compelling concern to regulators is the relative safety of householders' asset holdings. Every effort should be made to ensure that consumers have incentives to assess the risks they are taking and that unscrupulous individuals do not find ways to take advantage of householders' lack of sophistication. The possibilities for damage include fraudulent deposit schemes (as recently permitted in Albania, Romania, and Russia), badly managed pension funds (as in the Maxwell case in Britain and the failures of pension funds in Japan), conflicts of interest in selling mutual funds (consider the Stromberg Report[23] and the abuses created by the Principal Group), and the like.

All these matters are of real concern, and legislation should state principles making clear these concerns. Regulators should address any violations of the principles as quickly and as vigorously as possible, using both penalties and public exposure to deal with such problems.

As one means of guarding against abuses, we favor publicly disseminating financial information whenever doing so can be shown or presumed to be cost effective. The ratings of private financial agencies are useful, but they do not have access to the same information base as regulators. Since it is difficult to make valuations of nonstandardized asset portfolios less opaque unless supervisory information is published, all deposit insurance funds and the Office of the Superintendent of Financial Institutions (OSFI) should publicize what they deem to be pertinent indicators of supervised institutions' financial condition. Procedures for releasing the information should be worked out in consultation with industry representatives to ensure the information is as reliable as possible and to avoid arbitrary impositions of regulatory judgments. In the case of mutual funds, the risk-adjusted measure proposed by Leah Modigliani of Morgan Stanley[24] might prove a useful form of ranking.

Regular information release would mitigate what is now a dynamic problem created by sudden changes in expectations. Such release could gradually reveal changes in financial condition and, therefore, pose less risk of creating a liquidity crisis than does the present practice of making announcements only when an institution is nearly or wholly insolvent.

The announcement effects attendant on regular information release would also present an increasingly risky intermediary with a powerful incentive to alter its policies before it encountered solvency problems. As a result, publicly reporting information should also lessen the problems of safe institutions cross-subsidizing unsafe ones.

Commentators sometimes raise false concerns about greater disclosure. For example, some argue that announcing the risk-adjusted insurance premiums paid by different financial institutions could contribute to their failure. Although this might be the case when information is published for the first time, it would clearly not be the case after a disclosure scheme had been operating for a time. Difficulties with getting the scheme started might argue for its cautious introduction but not for its infinite deferral. In the longer run, timely revelation of information would help clients assess changing risks long before those risks reach the point of endangering an institution. Disclosure is especially important when there are many players with relatively short time horizons.

The current ability of the CDIC to keep confidential its premium assessments represents a management policy decision that should be reviewed. Although releasing these assessments might not always be politically expedient, we are not aware of compelling arguments against doing so. Moreover, as already pointed out, a number of arguments favor this and other kinds of information release. Regulatory authorities have greater resources and expertise to discriminate among different institutions' risks. Thus, so long as deposit insurance continues to be offered, it will remain up to organizations such as the CDIC, OSFI, and CompCorp to discourage institutions from taking what regulators and insurers deem to be undue risk.

Disincentives could extend beyond charging risk-based insurance premiums. For example, regulators could require weaker institutions to raise more capital — say, in the debentures market. A weak institution faced with a requirement to raise more capital would pay a premium for raising the additional funds, and that premium should provide at least some of the requisite disincentives to take on still greater risks. In cases of last resort, the regulatory authorities now have some power to take stronger action, and the recommendations of the 1995 White Paper[25] were intended to enhance these capabilities.

Overall, the several advantages of more information release must be weighed against the disadvantages. One such disadvantage is the cost of providing ratings schemes. Another is that information release might strain relations between regulators and regulated, making it difficult for the former to use finely tuned correctives. In our opinion, these disadvantages are outweighed by the advantages.

A third disadvantage is the issue of dynamic adjustment, but that would be of a temporary nature. Moving suddenly to a new system of information release could create dynamic instabilities during the adjustment period. For this reason, new forms of information release are probably best implemented gradually.

Summary

Our functional approach implies that similar functions should be administered under similar regulations. Subject to prudential concerns, restraints on types of business activity should be removed to encourage competition and hence resource allocation. Information release should be encouraged for similar reasons.

Our specific recommendations are as follows (in somewhat random order):

- *Retail versus wholesale transactions.* Because of the informational differences, retail transactions should generally be subject to more stringent disclosure standards than wholesale transactions among sophisticated counterparties.
- *Competitive versus prudential concerns.* The desirable balance of competitive and prudential concerns differs between retail and wholesale markets. For wholesale firms, the balance should probably tilt in the direction of competitiveness, while prudential concerns are more important in retail transactions.
- *Mutual funds.* Present disclosure law for and supervision of mutual funds is clearly insufficient. When published, the efforts of the industry and the Ontario Securities Commission need to be carefully assessed.
- *Pension funds.* Important proportions of households' assets are held in pension funds, for which regulation is also underdeveloped. When published, the findings of the Senate Banking Committee need to be carefully assessed.
- *Deposit insurance.* We advocate continuation of full coverage up to $60,000, but for each individual's dealings with a given financial institution, rather than for each account. We regard risk-adjusted premiums as a useful incentive for prudent management but recognize that, in some cases, in-

creasing premiums might not be a sufficient incentive for obtaining it.

- *Securities trading.* Urgent attention should be given to the formation of a national securities commission.
- *Job creation and economic growth.* Government should not restrict the workings of competition without a compelling tradeoff for doing so. Such tradeoffs occur rarely.
- *Competition, efficiency, and innovation.* The financial system cannot be expected to enter unprofitable markets willingly or to compete vigorously for unprofitable business. Innovation and financial restructuring are stifled by constraints that artificially divide up types of business or impose restrictive codes of practice.
- *International competitiveness.* We see little danger of a conflict between an internationally competitive system and strong, vibrant domestic institutions.
- *Equality of treatment.* Banks are currently limited in their ability to offer insurance products, an anticompetitive limitation that should be removed. Nor should banks be prevented from offering leases. Similarly, insurance companies should have access to the payments system, so long as they satisfy prudential concerns and pay appropriate access charges.
- *Financial affiliates.* Financial firms should be able to organize affiliated capital corporations so long as the regulators appropriately manage any prudential concerns.
- *The payments system.* Access to the payments system, especially Interac, is now an important determinant of competitive ability. Different risks may be posed if different classes of firms obtain access in the future. The original Interac members are entrepreneurs who have created an economically valuable entity and who are entitled to a fair return on their investment.
- *Equity ownership.* We believe that the market for effective control could be improved by relaxing, over the long term, the 10 percent limitation on the ownership of shares of banks and some other intermediaries.
- *Commercial-financial links.* We see no compelling reasons for generally limiting financial-commercial links, through either legislation or moral suasion. Nevertheless, such links may have to be monitored to satisfy prudential concerns and to ensure appropriate forms of information release.
- *Closely held small intermediaries.* The incentives for self-dealing can be compelling in some small, closely held depository intermediaries. Supervisors should concentrate attention on closely held institutions because problems have frequently arisen with them.
- *Emerging risks.* As financial institutions enter new businesses and merge to form new kinds of business combinations, they may assume risks with which they are unfamil-

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iar. Regulators should try to anticipate emerging difficulties and should be granted the resources to deal with such problems as they arise.

- *Fire and casualty insurance companies.* Functional analysis suggests that fire and casualty insurance companies are financial intermediaries and should be treated as such.
- *Narrow banks.* Restricting deposit insurance to narrow banks would not serve the public interest. Such a policy would be tantamount to dictating the form of portfolio that a financial institution should choose, rather than requiring it to pay risk-adjusted premiums for the insurance it purchases.
- *Physical presence.* The test of whether a business that engages in crossborder electronic commerce should be subject to a country's regulatory requirements involves the terms on which the institution sells its services or products.
- *Consumer responsibility.* Every effort should be made to ensure both that consumers have incentives to assess the risks they are taking and that unscrupulous individuals do not find ways to take advantage of householders' lack of sophistication.

- *Information release*. Since making nonstandardized asset portfolio valuations less opaque is difficult unless supervisory information is published, all deposit insurance funds and OSFI should publicize what they deem pertinent indicators of supervised institutions' financial condition. Procedures for releasing the information should be worked out in consultation with industry representatives to ensure it is as reliable as possible and to avoid arbitrary impositions of regulatory judgments.

Notes

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1 There is precedent for this assumption. See Anne Marie Slaughter, "The Real New World Order," *Foreign Affairs* 76 (September / October, 1997): 183–197.

2 Dwight B. Crane et al., *The Global Financial System: A Functional Perspective* (Boston: Harvard Business School Press, 1995).

3 On the other hand, some observers say that the existence of institutions such as the Canada Deposit Insurance Corporation can be viewed as a way of discouraging retail clients from ever learning to gather relevant safety information.

4 Stephen A. Ross, "Institutional Markets, Financial Marketing, and Financial Innovation," *Journal of Finance* 44 (1989): 541–556; and Sanford A. Grossman, "Dynamic Asset Allocation and the Efficiency of Markets," *Journal of Finance* 50 (1995): 773–787.

5 The fact that Canadian banks have combined their data-processing activities is evidence of scale economies, but it is of a clinical, rather than an econometric, nature.

6 Anthony M. Saunders, *Financial Institutions Management: A Modern Perspective* (Burr Ridge, Ill.: Irwin, 1994), p. 228.

7 A. Berger, D. Hancock, and D.B. Humphrey, "Bank Efficiency Derived from the Profit Function," *Journal of Banking and Finance* 17 (1993): 317–348.

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9 Ibid., p. 228.

10 *Globe and Mail* (Toronto), December 10, 1997.

11 For example, Alli Nathan and Edwin H. Neave, "Competitiveness and Contestability in Canadian Financial Industries," *Canadian Journal of Economics* 22 (1989): 576–594; and Sherrill Shaffer, "A Test of Competition in Canadian Banking," *Journal of Money, Credit and Banking* 25 (1993): 49–61.

12 Barry Scholnik, "Bank Spreads and Financial Deregulation in Canada" (working paper, Faculty of Business, University of Alberta, Edmonton, 1995).

13 Brian F. Smith, "Financial Reforms in Canada" (The Mutual Group Financial Services Research Centre, Wilfrid Laurier University, Waterloo, Ont., 1995).

14 Canada, Department of Finance, Task Force on the Future of the Canadian Financial Services Sector, "Discussion Paper" (Ottawa, June 1997).

15 For a recent assessment of the balance of costs and benefits to forming a national securities commission, see Jeffrey G. MacIntosh, "A National Securities Commission for Canada?" in Thomas J. Courchene and Edwin H. Neave, *Reforming the Canadian Financial Sector: Canada in Global Perspective*, Policy Forum series 34 (Kingston, Ont.: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1997).

16 Gloriana Stromberg, "Regulation of Investment Funds in Canada" (Toronto: Ontario Securities Commission, 1995).

17 Our list is taken from Canadian Bankers' Association, "Highlights of Submission to the MacKay Task Force," executive summary of CBA submission to the Task Force on the Future of the Canadian Financial Sector, *The Canadian Banker*, November / December, 1997, special insert. We do not include ownership limitations or restrictions on foreign banks here, but elsewhere in the text we recommend changes in these legislative provisions that would remove most of their value to the industry. On the restrictions on ownership by foreigners, see also James C. Baillie, "Silent Partners," Post 2000 Issue 10, *The Financial Post*, November 29, 1997, p. 8.

18 Interac Association, *Interac Source Book* (Toronto, 1994), p. 4.

19 Such a recommendation does present the issue of determining the appropriate time period. See Baillie, "Silent Partners."

20 See Colin Mayer, "Financial Systems and Corporate Governance: A Review of the International Evidence" (paper presented to a Conference on Financial Institutions in Transition: Banks and Financial Markets, Wallerfangen / Saar, Germany, 1997).

21 See Smith, "Financial Reforms in Canada."

22 There are also issues about the extent to which, in a *workout* — that is, the settlement of claims against a failed institution — the CDIC might incur costs so that all depositors are wholly covered. These issues, which relate to CDIC operations and, as such, are beyond the scope of this *Commentary*, are discussed in J.L. Carr, G.F. Mathewson, and N.C.Quigley, *Ensuring Failure: Financial System Stability and Deposit Insurance in Canada*, Observation 36 (Toronto: C.D. Howe Institute, 1994).

23 Stromberg, "Regulation of Investment Funds in Canada."

24 See "Mutual Funds," *The Economist*, May 24, 1997, pp. 72–73.

25 Canada, Department of Finance, "Enhancing the Safety and Soundness of the Canadian Financial System" (Ottawa, 1995).

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